



February 15, 2008

Dr. Mark B. Horton, Director
California Department of Public Health
1615 Capitol Avenue, MS 0500
P.O. Box 997377
Sacramento, CA 95899-7377

Dear Mr. Horton:

Final Report – Department of Public Health, Safe Drinking Water State Revolving Fund

The Department of Finance, Office of State Audits and Evaluations (Finance), has completed its financial statement and federal compliance audit of the Safe Drinking Water State Revolving Fund as of and for the year ended June 30, 2007.

The enclosed report is for your information and use. The California Department of Public Health's (CDPH) response to the report finding is incorporated into this final report.

For purposes of clarification, Finding A, Recommendation 1, is the result of applying the requirements of a new auditing standard and to correct what is now considered a material weakness in the internal control over financial reporting. Additionally, Finance will share and explain the financial statement adjusting entries and support documentation so CDPH can begin to prepare future adjusting entries. In accordance with Finance's policy of increased transparency, this report will be placed on our website.

We appreciate the assistance and cooperation of the CDPH. If you have any questions regarding this report, please contact Richard R. Sierra, Manager, or James Kong, Supervisor, at (916) 322-2985.

Sincerely,

Original signed by:

David Botelho, CPA
Chief, Office of State Audits and Evaluations

Enclosure

cc: Mr. Kevin Reilly, Acting Deputy Director, California Department of Public Health
Mr. Rufus Howell, Division Chief, Drinking Water & Environmental Management,
California Department of Public Health
Ms. Mary Cody, Audit Coordinator, California Department of Public Health

A F INANCIAL AND F EDERAL C OMPLIANCE A UDIT

California D epartment of P ublic H ealth
S afe D rinking W ater S tate R evolving F und
F or the F iscal Y ear E nded
J une 30, 2007

Prepared By:
Office of S tate A udits and E valuations
D epartment of F inance

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INDEPENDENT AUDITOR'S REPORT

Dr. Mark B. Horton, Director
California Department of Public Health
1615 Capitol Avenue, MS 0500
P.O. Box 997377
Sacramento, CA 95899-7377

We have audited the accompanying Statement of Net Assets, Statement of Revenue, Expenses, and Changes in Net Assets, and Statement of Cash Flows of the Safe Drinking Water State Revolving Fund (Fund) as of and for the year ended June 30, 2007. These financial statements are the responsibility of the California Department of Public Health's (Department) management. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with *Generally Accepted Government Auditing Standards* (GAGAS), issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to provide reasonable assurance as to whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management. We believe that our audit provides a reasonable basis for our opinion.

In connection with our audit, there are certain disclosures required by GAGAS. Both the audited entity and the Department of Finance, of which the Office of State Audits and Evaluations is a unit, are part of the State of California's Executive Branch, which GAGAS considers an impairment of independence. Also, as required by various statutes within the California Government Code, the Department of Finance's other units are mandated to perform certain management and accounting functions. These activities impair independence. Although the Department of Finance is statutorily obligated to perform these specific activities, we believe that sufficient safeguards and divisions of responsibility exist that would enable the reader of this report to rely on the information contained herein.

As discussed in Note 1, Definition of Reporting Entity, the financial statements of the Fund are intended to present the financial position, and the changes in financial position and cash flows, where applicable, of only that portion of the financial reporting entity of the Department that is attributable to the transactions of the Fund. They do not purport to, and do not present the financial position of the State of California as of June 30, 2007, or the changes in its financial position or its cash flows.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Fund as of June 30, 2007, and the changes in financial position and cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Fund's financial statements. The accompanying Schedule of Expenditures of Federal Awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the financial statements. Furthermore, the supplemental information listed in the Table of Contents is presented for additional analysis and is not a required part of the financial statements. The Schedule of Expenditures of Federal Awards and supplemental information have been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, are fairly stated, in all material respects, in relation to the financial statements taken as a whole.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing our opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Department's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Department's financial statements that is more than inconsequential will not be prevented or detected by the Department's internal control. We consider the deficiency described in the *Finding and Recommendations* section of this report to be a significant deficiency in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Department's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material

weaknesses. However, we consider the significant deficiency referred to above to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Department's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under GAGAS.

This report is intended solely for the information and use of Department management, those charged with governance, and state control agencies, and is not intended to be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Original signed by:

David Botelho, CPA
Chief, Office of State Audits and Evaluations
(916) 322-2985

January 11, 2008

STAFF:

Richard R. Sierra, CPA
Manager

James Kong
Supervisor

Chikako Takagi-Galamba
Amanda Bihlman

STATEMENT OF NET ASSETS

California Department of Public Health Safe Drinking Water State Revolving Fund June 30, 2007

ASSETS

Current Assets

Cash and pooled investments	\$ 67,497,552
Receivables	
Loan interest	2,340,690
Investment interest	738,162
Due from other funds	19,963,107
Due from federal trust fund	16,764,633
Current portion of loans receivable	<u>11,009,096</u>
Total Current Assets	<u>118,313,240</u>

Noncurrent Assets

Loans receivable	<u>441,705,718</u>
Total Noncurrent Assets	<u>441,705,718</u>

Total Assets	<u>560,018,958</u>
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LIABILITIES

Current Liabilities

Accounts payable	35,337,533
Due to other funds	<u>691,134</u>
Total Current Liabilities	36,028,667

Noncurrent Liabilities

Compensated absences payable	<u>343,829</u>
Total Noncurrent Liabilities	<u>343,829</u>

Total Liabilities	<u>36,372,496</u>
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NET ASSETS

Restricted	<u>523,646,462</u>
Total Net Assets	<u>\$523,646,462</u>

The accompanying notes are an integral part of this statement.

STATEMENT OF REVENUE, EXPENSES, AND CHANGES IN NET ASSETS

California Department of Public Health
Safe Drinking Water State Revolving Fund
For the Year Ended June 30, 2007

Operating Revenue	
Charges for loan interest	\$ 7,446,144
Charges for fines and penalties	<u>6,874</u>
Total operating revenue	7,453,018
Operating Expenses	
Salaries and benefits	3,654,901
Other expenses	3,662,259
Grant awards	<u>3,909,983</u>
Total operating expenses	<u>11,227,143</u>
Income (loss) from operations	(3,774,125)
Nonoperating Revenue	
Investment earnings	<u>2,806,187</u>
Total nonoperating revenue	<u>2,806,187</u>
Income (loss) before transfers	(967,938)
Transfers-in	
EPA capitalization grant	115,463,607
State match	398,463
Local government match	<u>1,996,852</u>
Total transfers-in	<u>117,858,922</u>
Change in net assets	116,890,984
Net assets—beginning	<u>406,755,478</u>
Net assets—ending	<u>\$523,646,462</u>

The accompanying notes are an integral part of this statement.

STATEMENT OF CASH FLOWS

California Department of Public Health Safe Drinking Water State Revolving Fund For the Year Ended June 30, 2007

CASH FLOW FROM OPERATING ACTIVITIES

Cash received from interest on loans	\$ 6,989,621
Loans disbursed	(112,924,001)
Principal received on loans receivable	10,226,736
Cash received for fines and penalties	6,874
Cash paid to employees and vendors	(11,140,274)
Payments for interfund services used	<u>(44,567)</u>
Net cash flows from operating activities	(106,885,611)

CASH FLOW FROM INVESTING ACTIVITIES

Interest received from investments	<u>2,656,993</u>
Net cash flows from investing activities	2,656,993

CASH FLOW FROM NONCAPITAL FINANCING ACTIVITIES

Transfers from the Environmental Protection Agency	116,274,583
Transfers from the State of California	398,463
Transfers from Local Governments	<u>1,996,852</u>
Net cash flows from noncapital financing activities	118,669,898

Net increase in cash and cash equivalents	14,441,280
Cash and cash equivalents—July 1, 2006	<u>53,056,272</u>
Cash and cash equivalents—June 30, 2007	<u>\$ 67,497,552</u>

Reconciliation of operating income (loss) to net cash flows provided (used) from operating activities

Operating income (loss)	\$ (3,774,125)
Adjustments to reconcile operating income (loss) to net cash provided (used) by operating activity	
(Increase) interest receivable	(608,717)
(Increase) loans receivable	(103,211,076)
(Increase) due from federal trust fund	(15,401,612)
(Increase) due from other funds	(18,172,057)
Increase accounts payable	34,239,674
(Decrease) due to other funds	(44,567)
Increase compensated absences payable	<u>86,869</u>
Total adjustments	<u>(103,111,486)</u>
Net cash flows from operating activities	<u>\$ (106,885,611)</u>

The accompanying notes are an integral part of this statement.

NOTES TO THE FINANCIAL STATEMENTS

California Department of Public Health Safe Drinking Water State Revolving Fund Year Ended June 30, 2007

NOTE 1 **Definition of Reporting Entity**

The California Department of Public Health (Department), formerly the California Department Health Services, administers the Safe Drinking Water State Revolving Fund (Fund). Created pursuant to Health and Safety (HSC) Code Section 116760.30, the Fund is continuously appropriated without regard to fiscal year and is financed by federal capitalization grants and state matching amounts. Pursuant to HSC Section 116760.40, the Department is allowed to enter into an agreement with a public water system to accept matching funds. In return, the public water system would receive a zero interest rate loan. The Department uses the Fund to make loans to public water systems to finance the cost of infrastructure needed to achieve or to maintain compliance with the Safe Drinking Water Act requirements and to protect public health.

The activities of the Fund are included in the State of California's Comprehensive Annual Financial Report. The Department administers the Fund, which includes the loan fund, the state match fund, and five set-aside funds: the Administration Account, Water System Reliability Account, Source Protection Account, Small System Technical Assistance Account, and Public Water System, Safe Drinking Water Revolving Fund. Public Water System, Safe Drinking Water Revolving Fund is a new set-aside fund that was created during fiscal year 2006-07 to pay for expenses that provide public water system oversight activities to support the Fund's loan and grant program. The establishment of the separate set-aside funds to account for the costs related to the administration of the Fund is consistent with federal guidelines. Each set-aside fund is a trust and agency fund, which uses the modified accrual basis of accounting. The funds are combined to form the Fund's financial statements.

NOTE 2 **Summary of Significant Accounting Policies**

Fund Accounting

The Fund is classified as an enterprise fund. Enterprise funds account for goods or services provided to the general public on a continuing basis when: (1) the department intends that all or most of the cost involved is to be financed by user charges, or (2) periodic measurement of the results of operations is appropriate for

management control, accountability, capital maintenance, public policy, or other purposes. The Fund applies all applicable Governmental Accounting Standards Board (GASB) pronouncements, pursuant to GASB Statement No. 20, as well as all applicable Financial Accounting Standards Board (FASB) Statements and Interpretations issued on or before November 30, 1989, unless the pronouncements conflict with or contradict GASB pronouncements. For purposes of the Statement of Cash Flows, all cash and pooled investments, as discussed in Note 4, are considered to be cash equivalents.

Measurement Focus and Basis of Accounting

The Fund is accounted for on the flow of economic resources measurement focus and the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when earned and expenses are recorded at the time the liabilities are incurred.

Principal Forgiveness Recognition

The Department may authorize principal forgiveness on loans disbursed to disadvantaged communities. Principal forgiveness is recognized as an expense as loan disbursements are made. As of June 30, 2007, the Department did not report principal forgiveness on any of the Fund's loans.

Compensated Absences

State employees are eligible to accrue annual leave, vacation, and sick leave. Annual leave accrues at a rate of 11 to 20 hours per month, with an annual accrual cap of 640 hours. Vacation accrues at a rate of 7 to 16 hours per month, with an annual accrual cap of up to 640 hours. Accrued annual leave and vacation are paid out upon termination while sick leave is not. As of June 30, 2007, the Fund's compensated absences totaled \$343,829.

NOTE 3 Capitalization Grants

The Fund is financed by annual grants from the U.S. Environmental Protection Agency (EPA) and a state match equal to 20 percent of the federal award.

Of the amount awarded by EPA, the Department has designated \$76.0 million for administrative expenses, program management, small system technical assistance, local assistance, and other state program expenses (collectively known as set-asides), and disbursed \$435.2 million for loans. Set-asides are accounted for in other funds.

The grants awarded, amounts drawn on each grant, and the loan balances available for active grants, as of June 30, 2007, are presented below:

Grant Year	Capitalization Grant Award	Award Available for Set-Aside	Award Available for Loans	Award Drawn for Loans	Available for Loans as of June 30, 2007
1997	\$ 75,682,600	\$ 10,048,176	\$ 65,634,424	\$ 65,634,424	\$ -
1998	77,108,200	4,934,925	72,173,275	72,173,275	-
1999	80,816,700	5,172,269	75,644,431	75,644,431	-
2000	83,993,100	2,000,000	81,993,100	79,793,445	2,199,655
2001	84,340,000	7,060,400	77,279,600	73,062,600	4,217,000
2002	82,392,347	6,879,101	75,513,246	68,931,870	6,581,376
2003	81,966,200	11,016,282	70,949,918	-	70,949,918
2004	84,957,600	16,601,008	68,356,592	-	68,356,592
2005	84,847,500	12,248,614	72,598,886	-	72,598,886

In the past, the state's matching contributions were provided through General Fund appropriations. Under federal guidelines, the state is not required to provide the match until the date it receives federal funds for a particular grant year. Since the Fund's inception, the state has contributed match totaling \$98 million.

NOTE 4 Cash and Pooled Investments

Cash in excess of current needs is deposited in the state's centralized treasury system, which combines the balances of state agencies into a single bank account to simplify cash management. The Surplus Money Investment Fund (SMIF) is managed by the Pooled Money Investment Board (PMIB). State statutes, bond resolutions, and investment policy resolutions allow the PMIB to invest in government securities, certificates of deposit, banker's acceptances, commercial paper, corporate bonds, mortgage loans and notes, other debt securities, repurchase agreements, equity securities, real estate, investment agreements, mutual funds, and other investments.

The reported amount represents an equity share in the balance of the investment pool. Since there are no individually owned investments, the deposit in SMIF is not reported by type of investment.

NOTE 5 Loans Receivable

The Fund makes loans to qualified local and private entities at interest rates ranging between 0 percent and 50 percent of the average rate paid by the state on general obligation bonds. Loans must be repaid within 20 years after completion of the project (30 years for financially disadvantaged communities). Recipients make semiannual or, in some cases, annual payments generally starting twelve months after project completion.

The Department disburses the loan proceeds on a cost reimbursement basis. As entities spend money on projects financed by the Fund and request reimbursement, the Department releases the loan proceeds. Interest accrues on all loan disbursements as of the date each disbursement is made.

There is no allowance for uncollectible accounts, as all repayments are current, and management believes all loans will be repaid according to the loan terms. There have been no loan defaults in the program since its inception.

Loans receivable activity during the year ended June 30, 2007, is summarized as follows:

Entity	Beginning Loan Balances July 1, 2006	Loans Issued as of June 30, 2007	Principal Payments as of June 30, 2007	Outstanding Loan Balances June 30, 2007
<i>Fully Disbursed Loans</i>				
Anaheim, City of	\$14,824,486	\$ -	\$ (776,204)	\$14,048,282
Angels, City of	1,265,957	-	(74,468)	1,191,489
Asoleado Mutual Water Company	40,320	-	(5,740)	34,580
Biola Community Service District	177,000	-	-	177,000
Brawley, City of	15,066,431	-	(997,550)	14,068,882
Colusa, County of	103,096	68,624	-	171,720
Contra Costa Water District	20,431,510	-	(971,147)	19,460,363
Crescent City, City of	6,300,000	-	(350,000)	5,950,000
Del Rey Community Svc District	172,380	-	(5,746)	166,634
Dunsmuir, City of	55,800	-	(2,790)	53,010
Dutch Flat Mutual Water Company	193,663	-	(8,065)	185,598
East Bay Municipal Utility District	2,015,032	-	(135,516)	1,879,516
East Valley Water District	165,671	-	(6,762)	158,909
Escondido, City of	1,886,214	-	(84,039)	1,802,175
Fort Bragg, City of	2,141,532	-	(107,077)	2,034,456
Grenada Sanitary District	570,333	-	(29,500)	540,833
Grizzly Flats Community Services Department	233,848	-	(10,157)	223,691
Humboldt Bay Municipal Water District	9,852,065	-	(821,005)	9,031,059
Imperial County	76,659	-	(5,244)	71,415
Imperial County Parks	146,789	-	(7,339)	139,450
Indian Valley Community Services District	111,286	-	(4,542)	106,744
Ivanhoe Public Utilities District	1,494,247	-	(37,356)	1,456,891
Konocti Bay (formerly Ford's Acres)	161,320	-	(7,713)	153,607
Lake Combie Mobile Home Village	50,607	-	(2,255)	48,352
Meadow Vista Co Water District	73,305	-	(13,938)	59,367
Metropolitan Water District	18,807,128	-	(819,195)	17,987,933
Redlands, City of	6,100,844	-	(120,479)	5,980,364
Richardson Beardsley Park, Inc.	52,495	-	(2,380)	50,115
River Pines Public Utility District	190,000	-	-	190,000
Rural North Vacaville Water District	7,715,820	-	(361,791)	7,354,029
San Diego, City of	20,685,053	-	(428,033)	20,257,021
San Jose Water Company	1,967,357	-	(80,267)	1,887,090
San Luis Obispo CFCD	299,704	-	(13,353)	286,351

Entity	Beginning Loan Balances July 1, 2006	Loans Issued as of June 30, 2007	Principal Payments as of June 30, 2007	Outstanding Loan Balances June 30, 2007
Santa Barbara, City of	35,615,956	1,584,097	(1,093,019)	36,107,034
Santiago County Water District	1,274,274	-	(52,350)	1,221,924
Sereno del Mar Water Co.	209,461	-	(10,783)	198,678
Serrano Water District	2,592,210	-	(231,070)	2,361,140
Shady Glen Enterprises	132,284	4,594	-	136,878
Sierra Lakes County Water District	1,256,171	-	(52,314)	1,203,857
Sierra Mobile Home Park	54,677	-	(2,956)	51,721
Solano Irrigation District	3,136,669	-	(69,553)	3,067,116
So. Humboldt Unified School Dist	25,039	-	(1,431)	23,608
Stinson Beach County Water Dist	403,416	-	(24,837)	378,579
Strathmore Public Utility District	451,500	-	-	451,500
Terra Bella Irrigation District	1,031,286	-	(66,041)	965,245
Truckee Donner Public Utility Dist	12,732,965	-	(505,843)	12,227,122
Tuolumne Utilities District	46,564	-	(3,676)	42,888
Vallejo, City of	5,159,063	-	(305,964)	4,853,099
Westmorland, City of	620,335	-	(33,532)	586,803
Yolo County Airport	249,333	-	(9,905)	239,428
Yuba City, City of	677,771	-	(36,636)	641,135
Fully Disbursed Loans Totals	199,096,926	1,657,315	(8,789,562)	191,964,679

Active Loans

Bella Vista Water District	8,231,634	1,485,550	-	9,717,184
Benicia, City of	7,954,217	3,693,358	-	11,647,575
Blythe, City of	6,495,022	3,312,138	-	9,807,160
Capell Valley Estates (Joe Family)	432,000	216,000	-	648,000
Carpinteria Valley Water District	13,916,650	2,564,829	-	16,481,479
Dinuba, City of	1,149,215	1,375,352	-	2,524,567
Eastern Municipal Water District	31,983,636	9,984,261	-	41,967,897
El Dorado Irrigation District	5,807,458	10,869,660	(258,405)	16,418,713
Fruitridge Vista Water Co.	-	2,840,183	-	2,840,183
Hillview Water Co., Inc.	410,888	3,069,782	-	3,480,670
Kerman, City of	2,361,363	311,764	-	2,673,126
Kings, County of	280,456	710,795	-	991,251
Lake Alpine Water Co.	1,986,161	215,571	-	2,201,732
Los Angeles, City of	16,321,647	55,377,615	(740,008)	70,959,255
Montecito Water District	5,860,386	2,480,640	-	8,341,026
North Marin Water District	14,186,742	859,102	-	15,045,844
Rio Dell, City of	1,751,541	968,459	-	2,720,000
San Buenaventura, City of	10,693,790	9,306,210	-	20,000,000
San Luis Obispo Co Flood Control & Water Conservation District	7,452,650	11,349,102	-	18,801,753
Santa Clara Valley Water District	-	5,575,741	-	5,575,741
Santiago Associates (Paradise Ranch)	617,713	-	-	617,713

Entity	Beginning Loan Balances July 1, 2006	Loans Issued as of June 30, 2007	Principal Payments as of June 30, 2007	Outstanding Loan Balances June 30, 2007
Sequoia Crest Water Co., Inc.	-	120,949	-	120,949
Sonoma County Water District	11,401,362	-	-	11,401,362
Spanish Flat Water District	206,890	65,623	-	272,513
Tracy, City of	-	18,249,848	-	18,249,848
Union Public Utility District	1,569,459	503,829	-	2,073,288
Active Loans Totals	151,070,882	145,506,360	(998,413)	295,578,829
Totals-All Loans	\$350,167,807	\$147,163,676	\$(9,787,975)	\$487,543,508

Loans mature at various intervals through June 1, 2036. The scheduled principal and interest payments on loans for fully disbursed projects maturing in the next five years and every five years thereafter are as follows:

	INTEREST	PRINCIPAL	TOTAL
FY 2007	\$4,593,599	\$11,009,096	\$15,602,695
FY 2008	4,381,843	11,227,171	15,609,014
FY 2009	4,158,233	11,450,781	15,609,014
FY 2010	3,928,948	11,680,067	15,609,015
FY 2011	3,693,941	11,899,381	15,593,322
FY 2012 - FY 2016	14,725,033	62,902,491	77,627,524
FY 2017 - FY 2021	8,042,072	66,925,023	74,967,095
FY 2022 - FY 2026	1,777,885	36,482,993	38,260,878
FY 2027 - FY 2031	0	245,260	245,260
FY 2032 - FY 2036	0	157,234	157,234
TOTALS	\$45,301,554	\$223,979,497	\$269,281,051

The amortization schedules for the active projects may change upon completion of the project when the final loan balance will be determined.

NOTE 6 Penalties & Fees

The Fund assesses a penalty of one-tenth of one percent (0.10 percent) per day from the repayment due date on the amount due on loan repayments past due. For the fiscal year ended June 30, 2007, the Fund collected \$6,874 in late payment penalties.

NOTE 7 Retirement Plan

Plan Description

The State is a member of the California Public Employees' Retirement System (CalPERS), which provides retirement and disability benefits, annual cost-of-living adjustments, and death benefits to plan members and beneficiaries. The Fund is included in the State Miscellaneous Category within CalPERS. CalPERS functions as an investment and administrative agent for participating public

agencies with the State of California, including the Fund. All risks and costs are shared proportionately by participating state agencies.

NOTE 8 Subsequent Events

- a. Effective July 1, 2007, the Department of Health Services was divided into two separate departments: the Department of Health Care Services and the Department of Public Health. Pursuant to Chapter 241, Statutes of 2006 (SB 162), specific programs and public health responsibilities were transferred from the former Department of Health Services to the newly established Department of Public Health. The Safe Drinking Water State Revolving Fund now falls under the administration of the Department of Public Health (Department).
- b. On August 31, 2007, the EPA awarded the Department a \$67.1 million capitalization grant for the period September 15, 2007 through June 30, 2017. The grant consists of \$58.4 million to the loan fund and \$8.7 million to the set-aside funds. In addition, the state's 20 percent match of \$18.1 million will be added to the loan fund. Allowable project costs under this capitalization grant total \$85.2 million.
- c. A loan disbursement of \$34,828,694 to the Los Angeles Department of Water and Power was pending as of June 30, 2007. After the fiscal-year end, the State Controller's Office (SCO) returned the unpaid claims because it needed more information to evaluate the allowability of the claims. As a result, the loan was not disbursed until August 27, 2007. The account balances in the audited financial statements are adjusted to reflect this event.

FINDING AND RECOMMENDATIONS

During our audit of the California Department of Public Health's (Department) Safe Drinking Water State Revolving Fund (Fund), we noted certain matters concerning the Department's accounting and administrative controls. We consider the following finding to be a material weakness. If left uncorrected, this weakness could compromise the accuracy of the Fund's financial statements.

FINDING Internal Controls over Financial Reporting Require Improvement

Condition: The Department needs to improve its internal controls over financial reporting. The existing controls failed to detect, prevent, and correct material misstatements in the Fund's financial statements. Specifically, the following weaknesses were noted:

- A. The Department did not prepare the year-end adjustments necessary for the presentation of the Fund's financial statements in accordance with Generally Accepted Accounting Principles (GAAP). The Department relies on its independent auditor to prepare the GAAP adjustments, such as compensated absences payable and entries to eliminate commitments from the reserve for encumbrances.
- B. No action was taken by the Department to correct the reversal of prior year transfer-in accruals recorded erroneously, which caused the transfer-in account balance to be understated by \$146,749,057 in the Fund's financial reports provided to the State Controller's Office (SCO).
- C. Contract 2000CX127 for a public entity was incorrectly established as "private," resulting in an overstatement of accounts payable and an understatement of due to local governments by \$2,825,780 in the Fund's financial reports provided to the SCO.

Criteria: California Government Code Sections 13401 and 13403, and State Administrative Manual (SAM) Section 20050 require each state agency to maintain effective systems of internal accounting and administrative controls. Such controls include procedures that ensure the preparation of accurate and reliable financial reports.

SAM Section 10445 states that general ledger account 3220 shows amounts due to local governments under various legal and contractual provisions, other than reimbursements for services received, which are accounted for in general ledger account 3010.

SAM Section 10608 states that all encumbrances unliquidated as of June 30 will be reviewed to determine whether they are valid obligations.

- Recommendations:
1. Prepare the year-end adjustments necessary for the presentation of the Fund's financial statements in accordance with GAAP. Provide training for the Department's accounting staff to enable them to prepare the adjustments.
 2. Follow-up and promptly correct prior reporting errors. Controls should include adequate management review and authorization of accruals and adjustments prior to submission of the financial reports to the SCO.
 3. Review outstanding encumbrances at June 30 for validity and proper classification.

SUPPLEMENTAL INFORMATION

SCHEDULE OF SET-ASIDE EXPENSES

California Department of Public Health
Safe Drinking Water State Revolving Fund
Year Ended June 30, 2007

	Administration Account	Water System Reliability Account	Small System Technical Assistance Account	Public Water System, Safe Drinking Water Revolving Fund	Total
Salaries and Benefits	\$1,842,835	\$ 681,135	\$1,051,674	\$79,257	\$3,654,901
Other Expenses	1,859,566	1,120,237	667,119	15,337	3,662,259
Totals	\$3,702,401	\$1,801,372	\$1,718,793	\$94,594	\$7,317,160



AUDITOR'S REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO THE FEDERAL PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133

Dr. Mark B. Horton, Director
California Department of Public Health
1615 Capitol Avenue, MS 0500
P.O. Box 997377
Sacramento, CA 95899-7377

Compliance

We have audited the compliance of the California Department of Public Health's (Department) Safe Drinking Water State Revolving Fund with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement that are applicable to the capitalization grants for the Safe Drinking Water State Revolving Fund program for the year ended June 30, 2007. Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of the Department's management. Our responsibility is to express an opinion on the Safe Drinking Water State Revolving Fund's compliance based on our audit.

Except as discussed in the following paragraph, we conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Generally Accepted Government Auditing Standards* (GAGAS), issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on the capitalization grants for the Safe Drinking Water State Revolving Fund program occurred. An audit includes examining, on a test basis, evidence about the Safe Drinking Water State Revolving Fund's compliance with those requirements and performing such other procedures, as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the Safe Drinking Water State Revolving Fund's compliance with those requirements.

In connection with our audit, there are certain disclosures required by GAGAS. Both the audited entity and the Department of Finance, of which the Office of State Audits and Evaluations is a unit, are part of the State of California's Executive Branch, which GAGAS considers an impairment of independence. Also, as required by various statutes within the California Government Code, the Department of Finance's other units are mandated to perform certain management and accounting functions. These activities impair independence.

Although the Department of Finance is statutorily obligated to perform these specific activities, we believe that sufficient safeguards and divisions of responsibility exist that would enable the reader of this report to rely on the information contained herein.

In our opinion, the Department complied, in all material respects, with the requirements referred to above that are applicable to its capitalization grants for the Safe Drinking Water State Revolving Fund program for the year ended June 30, 2007.

Internal Control Over Compliance

The management of the Department is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Department's internal control over compliance with requirements that could have a direct and material effect on its capitalization grants for the Safe Drinking Water State Revolving Fund program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

A *control deficiency* in the Department's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the Department's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the Department's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the Department's internal control.

Our consideration of the internal control over compliance was for the limited purpose described in the first paragraph of this section and would not necessarily disclose all deficiencies in the internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

This report is intended solely for the information and use of Department management, those charged with governance, federal awarding agencies, and pass-through entities, and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Original signed by:

David Botelho, CPA
Chief, Office of State Audits and Evaluations

January 11, 2008

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Summary of Auditor's Results

Financial Statements

Type of report the auditor issued	Unqualified
Internal control over financial reporting:	
Material weaknesses identified?	Yes
Significant deficiencies identified that are not considered to be material weaknesses?	No
Noncompliance material to the financial statements noted?	No

Federal Award

Internal control over the program:	
Material weaknesses identified?	No
Significant deficiencies identified that are not considered to be material weaknesses?	No
Type of report the auditor issued on compliance for the program	Unqualified
Any audit findings disclosed that are required to be reported in accordance with Section .510(a) of OMB Circular A-133?	No
Auditee qualified as low-risk auditee?	No

Identification of the program:

CFDA Number	Name of Federal Program
66.468	Capitalization Grants for Safe Drinking Water State Revolving Fund

Financial Statement Findings

One finding was noted. Refer to the *Finding and Recommendations* section of this report.

Federal Award Findings and Questioned Costs

No findings were noted.

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

California Department of Public Health
Safe Drinking Water State Revolving Fund
Year Ended June 30, 2007

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Federal Expenditures</u>
U.S. Environmental Protection Agency:		
Capitalization Grants for Safe Drinking Water State Revolving Fund	66.468	\$138,305,728

The accompanying notes are an integral part of this schedule.

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

California Department of Public Health Safe Drinking Water State Revolving Fund Year Ended June 30, 2007

NOTE 1 **Basis of Presentation**

The accompanying Schedule of Expenditures of Federal Awards (schedule) includes the federal Capitalization Grants for Safe Drinking Water State Revolving Fund grant activity of the California Department of Public Health (Department). The schedule is presented on the accrual basis of accounting. The information presented in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Accordingly, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the financial statements.

NOTE 2 **Loans to Subrecipients**

Of the federal expenditures presented in the schedule, the Department disbursed \$127,563,676 million in loan proceeds to subrecipients in the current year.

NOTE 3 **Subsequent Event**

The loan disbursement of \$34,828,694 to the Los Angeles Department of Water and Power was pending as of June 30, 2007. The loan included federal funding of \$15,228,694 and state match of \$19,600,000. Subsequent to the state's fiscal year-end, the State Controller's Office returned the claim schedules because it needed more information to evaluate the allowability of the claims. As a result, federal funds of \$15,228,694 were held in the state account for 55 days, from July 3, 2007 to August 27, 2007.

DEPARTMENT'S RESPONSE



MARK B HORTON, MD, MSPH
Director

State of California—Health and Human Services Agency
California Department of Public Health



ARNOLD SCHWARZENEGGER
Governor

Janet I. Rosman, Assistant Chief
Department of Finance
Office of Audits and Evaluations
300 Capitol Mall, Suite 801
Sacramento, CA 95814

Dear Ms. Rosman:

The California Department of Public Health (CDPH) has prepared its response to the California Department of Finance draft report entitled, "Draft Audit Report: Department Of Public Health, Safe Drinking Water State Revolving Fund." The CDPH appreciates the opportunity to provide the Department of Finance with its response to the draft report.

Please contact Rufus Howell, Acting Deputy Director, Center for Environmental Health, at (916) 445-0275, should you have any questions.

Sincerely,

Original signed by:

Mark B Horton, MD, MSPH
Director

Enclosure

cc: Rufus Howell
Acting Deputy Director
Center for Environmental Health
MS 0511
P.O. Box 997377
Sacramento, CA 95899-7377

**Department of Public Health, Safe Drinking Water
State Revolving Fund Audit Response**

Findings

- A. The Department did not prepare the year-end adjustments necessary for the presentation of the Funds financial statements in accordance with Generally Accepted Accounting Principles (GAAP). The department relies on its independent auditor to prepare the GAAP adjustments such as compensated absences payable and entries to eliminate commitments from the reserve for encumbrances.

Audit Recommendations:

1. Prepare the year-end adjustments necessary for the presentation of the Fund's financial statements in accordance with GAAP. Provide training for the Department's accounting staff to enable them to prepare the adjustments.

Response:

CDPH agrees with the audit finding. Past practices were agreed upon between DOF and CDPH to prepare the GAAP adjustments. We have since been informed that this is no longer allowed based on a recent ruling by DOF. We have requested training from DOF Auditors on this process by providing the accounting staff with the working papers that supported past GAAP adjustments as a tool for such training. DOF Auditors have agreed to set up a training session with CDPH Accounting staff so that the department can prepare all future GAAP adjustments for SDWF without relying on the independent auditors' assistance. Coupled with the aforementioned arrangement the accounting staff will have access to the GAAP guidelines provided by the State Controller's Office that will be used to provide additional information for the accurate and timely preparation of future GAAP adjustments.

- B. No action was taken by the Department to correct the reversal of prior year transfer-in accruals recorded erroneously which caused the transfer-in account balance to be understated by \$146, 749,057 in the Fund's financial reports provided to the State Controller's Office (SCO).

Audit Recommendations:

2. Follow-up and promptly correct prior reporting errors. Controls should include adequate management review and authorization of accruals and adjustments prior to submission of the financial reports to the SCO.

Response:

CDPH agree that the accounting staff failed to take appropriate action to correct in CALSTARS the prior year's financial statement's erroneous accrual entry for transfers-in which was automatically reversed in the following year. Such known needed corrections will be acted upon promptly. The Accounting office has since reorganized into a functional setting. Accounting now has a unit that deals exclusively with preparing the financial statements for reporting to the SCO. There will be first and second levels of review before the final review by the Accounting Chief to insure more accurate statement submission.

C. Contract 2000CX127 for a public entity was incorrectly established as "private," resulting in an overstatement of accounts payable and an understatement of due to local governments by \$2,825,780 in the Fund's financial reports provided to the SCO.

Audit Recommendations:

3. Review outstanding encumbrances at June 30 for validity and proper classification.

Response:

CDPH agrees with this Audit Finding, that Contract 2000CX127 was erroneously established as a 'Private' entity and should have been established as a 'Public' entity causing an overstatement of accounts payable and an understatement of due to local governments by \$2,825,780 in the Fund's financial reports provided to the SCO. We have an established routine within our Year-End Work Plan to verify appropriate vendor types by using the CALSTARS D07, Year-End Document File: Report of Encumbrances. Staff is required to use the D07 report to review each document and verify that the vendor type is appropriately assigned. This routine is repeated three times during our Year-End closing process. In the case of this audit finding, the contract had not yet been encumbered, and therefore not listed on the CALSTARS D07 report. The staff has now been alerted to the circumstances leading to this error and will be more conscientious in establishing the correct vendor types when reporting their accrual information.